No. 11,795

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

ESTATE OF ISADORE ZELLERBACH, Deceased, J. David Zellerbach and Harold L. Zellerbach, Executors,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

APPELLANT'S REPLY BRIEF.

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Subject Index

Table of Authorities Cited

Cases

Statutes

Regulations

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RESTATEMENT OF QUESTION PRESENTED.

Counsel for appellee (hereinafter referred to as respondent) on page 2 of their brief, state the question presented as follows:

> "Whether, in determining its taxable net income for 1942 and 1943, the taxpayer estate is entitled, under Section 162(b), (c), or (d)(1) of the Internal Revenue Code, to deduct, in addition to the income distributed to the legatees under the decedent's will, all of the remaining income in each year, although such income was not distributed, was not to be distributed currently, and was not credited, to the legatees in those years."

This is not, in our opinion, a correct statement of the question, and the following more correctly expresses it:

Whether in determining its taxable net income for 1942 and 1943, the taxpayer's estate is entitled, under Section 162(b), (c) or (d)(1) of the Internal Revenue Code, to deduct, in addition to the income distributed to legatees under decedent's will, all of the remaining income in each year although such income was not distributed, where (1) the legatee who was entitled to such income or the executors could have petitioned to the Probate Court for a distribution of such, and said legatee reported such income in her income tax returns as having been received by her and paid the tax thereon, and accordingly, whether said legatee in 1942 and 1943 had a present right to such income, and further (2) whether the ordinary duties pertaining to the administration had been completed and it was deemed that the estate had been distributed and the income taxable to the legatees, and (3) whether under Section 162(d)(1) of the Internal Revenue Code a distribution of corpus in a year in which the estate had distributable income is taxable to the legatees to the extent of the distributable income.

REPLY TO RESPONDENT'S ARGUMENT WITH RESPECT TO SECTION 162(b) OF THE INTERNAL REVENUE CODE.

In Part A of the appellee's summary of argument (Respondent's Brief, page 9) counsel for appellee states:

> "Although the legatees had the right to petition the Probate Court for distribution of the income and, if the statutory procedure for notice and hearing was complied with and if the facts required by the California statutes were made to appear at the hearing, to have orders made in their favor, nevertheless, the entry of orders for distribution was not available as a matter of right but depended on the precedent statutory steps. These steps were not taken in 1942 and 1943. It follows that the undistributed income was not currently distributable in those years."

In answer to this argument we call attention to the authorities which we cited on pages 17 to 19 of appellant's opening brief interpreting the relevant provisions of the California Probate Code, and in particular to the case of *Henry S. Stephenson, deceased,* 65 Cal. App. (2d) 120, wherein the Court stated:

> "The Probate Code clearly gives power to the court to order a partial distribution of an estate and, given the prescribed conditions, it is made *mandatory* upon the court to make the order."

As we also pointed out on pages 21 to 24 of our opening brief, all the prescribed conditions had been met and there was no discretion left for the Probate Court to exercise. If a formal petition had been filed either by the executors or Jennie B. Zellerbach, the widow and a residuary legatee, to distribute the remaining undistributed income for each of the years 1942 and 1943, the Court would have distributed it and could not have legally done otherwise.

Under such state of facts, the respondent's conclusion that "It follows that the undistributed income was not currently distributable in those years" is not sound, particularly in view of the Commissioner's own regulations, Section 29.162-2(b), which provides as follows:

> "As used in Section 162, the term 'income which becomes payable' means income to which the legatee, heir, or beneficiary has a present right, whether or not such income is actually paid. Such right may be derived from the directions in the trust instrument or will to make distributions of income at a certain date, or from the exercise of the fiduciary's discretion to distribute income, or from a recognized present right under the local law to obtain income or compel a distribution of income."

Nowhere does counsel for the respondent discuss the above regulations and point out wherein it does not apply to the facts in the instant case.

Counsel states on page 17 of their brief that

> "Because * * * the right to distribution depended upon an order for distribution by the court, and because no orders were made or obtainable as a matter of right, it necessarily follows that the undistributed income in 1942 and 1943 was not currently distributable in those years by virtue of California law within the meaning of Section 162(b)."

and on page 20 of their brief:

> "The argument (Br. 22-24) that a widow had a 'present right' to distribution of the remaining

> income in 1942 and 1943 because the three children received their share of the income in those years has no merit."

In footnote 4 on page 20, counsel for respondent states further:

> "In view of the express provisions in Section 162(b) of the Code and Section 29.162-2(b) of Treasury Regulations 111, the Government has never contended, nor did the Tax Court hold, that actual distribution of the widow's share of the income to her was necessary for Section 162(b) to apply. Thus, the taxpayer's 'third point' (Br. 24-28) seems to have no relevance, the fact that actual distribution is not required by Section 162(b) being admitted."

Since counsel concedes that *actual distribution is not required,* we submit that the rest of their contentions are without merit. The regulation above quoted states that the "present right" as used therein may be derived from any one or more of the following three propositions:

(1) Directions in the will to make distributions of income at a certain date;

(2) The exercise of the fiduciary's (executor's) discretion to distribute income; and

(3) A recognized present right under the local law to obtain income or compel a distribution of income.

In answer to points 1 and 2 we call attention to the following language on page 12 of respondent's brief, wherein they state:

> "The testator's will itself contained no provision directing that the income received by the estate during the period of administration was to be distributed currently to the legatees named by him. (R. 138.) *On the contrary, the will implies that distribution of the income was to be discretionary with the executors, since they were given complete power to deal with the estate or any part according to their judgment and discretion and without court order.*" (Italics ours.)

It is obvious from the record that the executors had a discretion, otherwise they could not have arbitrarily petitioned for distribution of one-sixth of the income to each of the children while not petitioning for any distribution of the income to the widow, yet at the same time petitioning for a distribution of a considerable amount of corpus, which distribution of corpus was on a proportionate basis with the widow included in such distribution. (Tr. pp. 62-65, 68-72, 93-97, 87-89, 80-84.)

The third point, namely, a recognized present right under the local law to obtain income or compel a distribution of income we have discussed at length at pages 12 to 24 of our opening brief, and for that reason we do not repeat any of said argument herein.

Finally, counsel for the respondent states on page 20 of their brief as follows:

> "The argument (Br. 22-24) that the widow had a 'present right' to distribution of the remaining income in 1942 and 1943 because the three children received their share of the income in those

> years has no merit. The right of the widow to the distribution at some time of a share of the income for those years in the proportion given her by the testator is not disputed, but the question is whether her share was presently distributable in 1942 and 1943. Since her right to current distribution depended on entry of orders of distribution in her favor, which were not entered, it is irrelevant that orders had been entered authorizing distribution of other amounts to other legatees."

We submit that if the respondent's theory is adopted, namely, that it is necessary to obtain orders from the Probate Court, under the circumstances herein presented, before an estate may claim a deduction for income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated (Sec. 162(c)), then the provisions of Section 162 of the Internal Revenue Code may entirely be circumvented by the mere device of not applying for decrees of distribution of income and merely applying for distribution of the corpus which in the case of large taxpayers may be very advantageous taxwise. We further submit that our theory correctly expresses the interest of Congress in enacting the provisions of Section 162 of the Internal Revenue Code. In this connection we call attention to the comparatively recent case of *William C. Chick v. Commissioner,* 7 T. C. 1414, wherein the executors had not distributed the estate and the Commissioner had ruled that the administration of the estate had

been unduly prolonged, that the estate was no longer in the process of administration, and taxed the income to the beneficiaries of the estate under Section 162(b), notwithstanding that *there had not been any decrees of distribution.* The Tax Court upheld the Commissioner, and we call attention to the following language appearing on pages 1421 and 1422 of the opinion:

> "As we understand petitioners' argument, it is that only the probate courts of the State of Massachusetts can determine when an administration is closed in the State of Massachusetts, and that it naturally follows that as long as such administration is not closed the estate must be considered 'in process of administration,' and the income of the estate must be taxed under the Federal statute to the estate and not as the income of the testamentary trust provided in decedent's will. If petitioners' position is correct, then it seems to follow that an administration can be prolonged indefinitely in the state courts and long after any need for it exists, and the income of the estate be still taxable to it as a separate entity and not to any testamentary trust provided in the will. Our Court has not subscribed to that doctrine and in several cases we have given approval to the part of Regulations 103 which is printed in the margin."

In conclusion, we call attention to the language appearing in the case of *Carlisle v. Commissioner,* 165 Fed. (2d) 645, 648, (cited by respondent in connection with Section 162(d)(1)), wherein the Commissioner taxed the beneficiaries of a will with income

as having been received in 1942 although no formal order was made until 1943, which language is as follows:

> "It is quite true that authority from the Probate Court for the October 1942 distribution was neither applied for nor allowed until January, 1943, but the tax court was not in error in viewing the proceedings as mere formalization of authority exercised in 1942."

(The facts are set forth in detail in the opinion of the Tax Court reported in 8 T.C. 563, 564.)

We submit that these cases definitely show the fallacy of the respondent's contention that it is necessary to obtain formal orders of the Probate Court before income may be taxed to a beneficiary. The Commissioner certainly has taken contrary positions in the *Carlisle* case, *supra,* and the instant case. The taxpayer in the *Carlisle* case was contending that since no order was obtained in 1942, the income was not distributed in that year, to which contention the Commissioner replied that orders were not necessary, and both the Tax Court and the Circuit Court upheld him. In the instant case the Commissioner states that orders are necessary before income may be deemed distributable in a particular year, to which contention we say that neither the Code nor the regulations require a formal order and that under the statement of the Court the Tax Court should have determined that the estate was entitled to a deduction for all the income in both 1942 and 1943.

REPLY TO RESPONDENT'S ARGUMENT WITH RESPECT TO SECTION 162(c) OF THE INTERNAL REVENUE CODE.

On page 9 of respondent's brief, counsel for respondent state as follows:

> "The undistributed income for 1942 and 1943 may not be deducted by the taxpayer under Section 162(c) of the Code, because it was not properly credited in those years to the legatees entitled to receive it under the testator's will. There is no evidence that the unpaid income was made unconditionally available to the legatees in 1942 and 1943, and thus there was no credit, as the term is used in the statute."

In answer to this argument, we call attention to the record in the instant case. First, under the decedent's will the residue of the estate was distributed three-sixths to Jennie B. Zellerbach, and one-sixth each to J. David Zellerbach, Harold L. Zellerbach and Claire Zellerbach Saroni. In the petition for partial distribution of the income which was filed by the executors in the year 1942 (Tr. pp. 62-65) the executors allege that for the calendar year 1942 the estate had income in the sum of $317,000, of which the widow was entitled to one-half, but which income they desired to distribute $22,000 to Jennie B. Zellerbach and $53,000 to each of the other residuary legatees, making a total distribution of $181,000. The Court decreed that said distribution could be made without injury to the estate or any person interested therein. (Tr. p. 67.) We submit that by such petition and decree there was *ipso facto* allocated to Jennie B. Zellerbach the balance of the undistributed income

for the year 1942, to-wit, the sum of $137,000, because of the fact that there can be no preference in distributions among persons of the same class, residuary legatees being all in the same class. Therefore, the executors' very act taken in the Probate Court was tantamount to an allocation to Jennie B. Zellerbach of her proportionate amount of the income for said year. It was made unconditionally available to her by the filing of the petition for partial distribution and the decree of the Probate Court based thereon. The evidence in the case conclusively shows that at all times there were sufficient assets available in the hands of the executors to have paid the amount of income to which Jennie B. Zellerbach was entitled. If there had not been, the Court would not have dispensed with the giving of a bond by the distributees, (Tr. p. 67) which bond it could have required under the provisions of Section 1001 of the California Probate Code. What we have said with respect to 1942 is equally true for the year 1943.

Furthermore, Jennie B. Zellerbach reported the entire income as having been received by her for each of the years 1942 and 1943, and the estate claimed credit therefor in its amended returns which indicated that the executors had allocated the income to Jennie B. Zellerbach. (Tr. pp. 45, 53.) We can see no appreciable difference between the instant case and the *Estate of Igoe v. Commissioner,* 6 T. C. 639.

Finally, the respondent argues that because the estate had large amounts of unpaid liabilities, that the estate was still in the process of administration under

the California law. On pages 44 to 46 of appellant's opening brief we point out the regulations in connection with this subject matter. We submit that in view of the fact that the executors were distributing large amounts of the corpus of the estate and that the assets of the estate, even after the distribution of the large amounts of the corpus, were still approximately three times the amount of the unpaid liabilities, that the administration of the estate was to all intents and purposes closed within the meaning of the provisions of Section 29.162-1(c) of the regulations quoted at page 45 of appellant's opening brief.

We also call attention to the case of *William C. Chick v. Commissioner, supra,* and in particular to the language therefrom quoted above. It is obvious that if the executors had desired, they could have very readily discharged the liabilities and wound up the estate.

REPLY TO RESPONDENT'S ARGUMENT WITH RESPECT TO SECTION 162(d)(1) OF THE INTERNAL REVENUE CODE.

Respondent argues that because the distributions of the corpus made in the years 1942 and 1943 were bequests of the residue, and were not under the will payable at intervals, that the provisions of 162(d)(1) do not apply, citing *Carlisle v. Commissioner,* 165 Fed. (2d) 645.

We find nothing in this decision which states that the provisions of Section 162(d) of the Internal Revenue Code, as contained in the 1942 amendment to

Section 162(b), make it applicable only to those situations where the will provides that a bequest is to be paid at intervals. The holding of the Court is stated in the first headnote to the decision as follows:

> "The 1942 amendment of the Revenue Code relating to deductions from net income of an estate or trust in amount of income distributed currently, including income which becomes payable to legatee, heir, or beneficiary was intended to include in income of legatee or beneficiary, the income of an estate or trust which became payable to legatee or beneficiary in year of receipt though constituting part of an accumulation of income paid to residuary legatee upon termination of estate. 26 U.S.C.A. Int. Rev. Code, Secs. 22(b), 162(b)."

We quoted on pages 38 and 40 of appellant's opening brief from General Counsel's memorandum opinion No. 24702, the last paragraph of which opinion reads as follows:

> "Accordingly, it is the opinion of this office that amounts distributed by an estate out of its income during the taxable year in which the residue becomes payable are, to the extent the estate had income (other than income in respect of a decedent) for such taxable year, taxable to the legatee and deductible by the estate under Section 162(b) of the Internal Revenue Code, as amended by Section 111 of the Revenue Act of 1942, regardless of the fact that under State law such income is considered principal to the legatee, except where the distribution is made in satisfaction or payment of a pecuniary legacy. (See

Old Colony Trust Co. et al v. Commissioner, 38 B.T.A. 828 (CCH Dec. 10, 458), and *Arthur H. Wellman v. Welch,* 99 Fed. (2d) 75 (38-2 U.S. T.C. Sec. 9508), with respect to the exception.)"

As we have pointed out on page 35 of appellant's opening brief, quoting from the record, in 1942 there was distributed corpus of a value of $1,146,000; in 1943 there was distributed corpus of a value of $30,950, and that under these circumstances the amounts distributed by an estate out of residue (all of said distributions being out of residue), to the extent that the estate had distributable income, will be deemed distribution of income.

CONCLUSION.

In conclusion, appellant again respectfully submits that the evidence in this case clearly sets forth that the entire income of the estate of the decedent taxpayer, the appellant herein, for the years 1942 and 1943 should be deemed as having been distributed in full to all the residuary legatees of the estate in the proportions which they take under the decedent's will; that the estate is entitled to a credit for all of such income, the same having been included in the respective income tax returns of the residuary legatees for each of said years; that the Tax Court erred in holding said legatees (beneficiaries) had no present right to the 1942 and 1943 income of the appellant; that it further erred in holding that the

appellant was not entitled to any deduction for the years 1942 and 1943 under Section 162(c) of the Internal Revenue Code in addition to the amounts actually distributed out of income; that the Tax Court further erred in holding that the provisions of Section 162(d)(1) of the Internal Revenue Code was not applicable.

Finally, the appellant contends, and respectfully submits, that the decision of the United States Tax Court should be reversed; that the determination that there were deficiencies in the income taxes for the years 1942 and 1943 in the respective amounts of $1,768.55 and $67,388.46 was erroneous and should be reversed and in lieu thereof it should be determined that the appellant is entitled to a refund for the year 1942 in the amount of $71,585.08, and that there is no income tax due from the appellant for the year 1943.

Dated, San Francisco,
May 10, 1948.

Respectfully submitted,
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